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SUBJECT: NBU STABILIZES HRYVNIA, BUT FURTHER WEAKENING NECESSARY

REF: A) KYIV 2198 AND PREVIOUS
B) KYIV 2207

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Summary

1. (SBU) The hryvnia has stabilized in the past week as a result of the National Bank of Ukraine's new policy to sell unlimited amounts of dollars at an exchange rate that it resets daily. The strategy is probably draining the NBU's reserves, which stood at \$31.9 billion on October 31, but the NBU is not saying by how much. The central bank has adopted additional harsh measures to stabilize the hryvnia. It has ordered banks to buy and sell dollars in an extremely tight range, drastically reduced the amount of money that Ukrainians can transfer abroad, and ordered the closing of the country's ubiquitous foreign exchange kiosks as of January 1, 2009. The NBU faces strong political pressure to keep the hryvnia stable, and to even allow it to appreciate, and the measures may well be necessary in the short term to prevent further runs on banks. Ukraine must allow the hryvnia to depreciate, however, if it is to seriously tackle the ballooning current account deficit. The IMF is aware of the policy trade-off that the NBU is facing, and believes that the current policies can only be a short-term solution that will ultimately need to give way to more exchange rate flexibility. Looking forward, the NBU faces significant challenges if tries to manage an orderly depreciation when politicians and popular sentiment may be calling for just the opposite. End summary.

NBU Stabilizes Exchange Rate, For Now

2. (SBU) The National Bank of Ukraine's (NBU) heavy handed efforts to stabilize the hryvnia are working, at least for the moment. Since late October, the NBU has issued a daily statement announcing its willingness to sell unlimited amounts of dollars at a pre-determined rate. Each day, the NBU has reset the rate downwards to allow the hryvnia to appreciate gradually. The strategy has worked: before it implemented the policy, the hryvnia crossed the 7 UAH/\$ mark briefly. It traded at about 6.20 UAH/\$ on the first day of the NBU's new strategy, and at 5.81 UAH/\$ on November 6. Rates in the interbank market, and at the retail level in the many foreign exchange kiosks on the streets of Ukraine's cities, have largely mirrored the rate set by the NBU.

But At What Cost?

3. (SBU) The willingness to satisfy market demand has probably drained the reserves of the NBU. It is unclear, however, how many dollars the central bank has lost implementing the strategy. As of Oct. 31, reserves were \$31.9 billion (down 14.9 percent in October and from a high of \$38 billion earlier this year), but that was

before the NBU implemented the current policy in earnest. It has not announced how many reserves it needed to sell to maintain the policy since Oct. 31.

NBU Reduces Forex Market to That of An Agent

¶4. (SBU) Accompanying the strategy are new, harsh administrative measures that, taken together, reduce the role of Ukraine's foreign exchange market to an agent that executes transactions at prices determined by the NBU. On November 5 the NBU issued a resolution requiring banks to resell any dollars they buy at precisely the rate set by the central bank. Banks may purchase dollars at a rate no lower than three percent below the official NBU rate. In addition, banks are not allowed to hold inventories of dollars for their trading operations. All dollars purchased from the NBU must be resold on the same day, or the next day at the latest. Taken together, these measures mean that all dollar transactions in Ukraine -- either between banks, between banks and clients, or on the street -- are locked into a tight corridor dictated by the NBU.

¶5. (SBU) The NBU took this latest step after banks routinely resold dollars purchased from the central banks with a markup, which ranged anywhere from 5 to 30 percent in the last week, depending on demand. Analysts have pointed out that such markups simply imply that the correct dollar rate is somewhat higher than the rate set by the NBU, but the central bank is determined to compel the market to trade at rates that it, the NBU, believes are necessary to stabilize the currency.

NBU Also Caps Transfers

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¶6. (SBU) The NBU announced other measures as well. Companies wishing to purchase dollars had already been required to document a need for the currency before buying. Now, companies must use the purchased dollars within five days or resell the dollars on the interbank market. In addition, Ukrainian residents are now limited to transferring from 15,000 UAH to 75,000 UAH (about \$2,500 to \$12,500) abroad each month. Before the change, residents could transfer 15,000 UAH abroad daily.

NBU To Shut Down Kiosks

¶7. (SBU) To further control the market, the NBU also announced that foreign exchange kiosks, ubiquitous throughout Ukraine and the place where most ordinary citizens exchange money, must close on January 1 at the latest. Thereafter cash transactions will only be permissible at bank counters. Kiosks not owned by banks are regulated by another state agency. By all accounts, the kiosks are currently well-regulated, and they are fully subject to the country's anti-money laundering and terrorism finance regimes. Hence the NBU action cannot be justified by the need to improve supervision of the kiosks. Instead, they are a clear attempt to broaden NBU control over the cash foreign exchange market, and will certainly be unpopular among Ukrainians, who can now exchange money seven days a week at kiosks co-located in grocery stores and other retail outlets. It will also increase costs for banks, many of which will have expand their opening hours to service clients who now use kiosks.

An Estimated \$50 Billion Cash Now In The Country

¶8. (SBU) Both the NBU and analysts have argued that the recent surge in bank withdrawals and sharp devaluation of the hryvnia was driven primarily by ordinary Ukrainians anxious to protect their savings from inflation and further devaluation. On November 5, however, the NBU reported that Ukrainian residents only purchased a net \$938 million of the \$4.1 billion sold by the NBU in October. Some commentators are now claiming that subsidiaries of foreign banks eager to repatriate dollars were among the biggest buyers. In any case there is universal acknowledgement that ordinary residents

launched a run on banks after the Prominvestbank affair broke (ref B). The NBU reported that residents withdrew \$1.78 billion from banks in October, or 11.3 percent of their total deposits. Nervous residents withdrew hryvnia from their bank accounts and exchanged them into dollars. (Note: The country director of a large foreign company told us that his chief treasurer led the charge among his employees; the nervous treasurer encouraged his colleagues to withdraw their money from banks "before it was too late." The news, coming from someone they naturally considered to be an expert on money matters, prompted employees to desert their desks and dash to their banks, we were told. Separately, a vice president of Nadra Bank told us that his bank has no available safe deposit boxes after a recent surge of interest from retail clients. End note). Most of those dollars are still in Ukraine, in the form of cash kept in bank safe deposit boxes or literally stuffed under mattresses. It is estimated that up to \$50 billion of dollar cash may now be in the country, which would be nearly enough to cover Ukraine's expected external financing need in 2009.

Political Pressure TO Stabilize Exchange Rate

¶9. (SBU) The NBU clearly expects that freezing the hryvnia into a tight range is necessary to restore confidence in both the currency and the banking system. A continued weakness could prompt further runs on bank deposits, cause some banks to collapse, and quickly undermine the confidence that the \$16.5 billion IMF support plan approved on November 5 is supposed to provide. The NBU's actions also reflect the sensitivity that the exchange rate has in Ukraine, and the political pressure that the central bank is facing. During the hryvnia's recent slide, all political parties openly criticized the NBU for not taking decisive actions to stabilize the currency. Politicians of all colors, including President Yushchenko, continue to call for a stable exchange rate. On November 6 Oleksandr Shlapak, first deputy head of the Presidential Secretariat, even assured Ukrainians that the hryvnia would remain at around 6 UAH/\$ in 2009.

Comment: NBU Faces Policy Dilemma

¶10. (SBU) The NBU is not only stabilizing the currency, but even pushing it to appreciate gradually in nominal terms. The NBU may be thinking that nominal appreciation is necessary in the short run to

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reestablish trust in the currency. It may work, but if confidence does not return quickly then the strategy could cause a severe drain on the NBU's reserves. Dictating the exchange rate could also lead to the rebirth of a black market for dollars, which has all but disappeared in Ukraine in recent years. Most importantly, the NBU actions could soon conflict with other monetary policy goals. The hryvnia needs to depreciate, both in nominal and real terms, if Ukraine is to seriously combat its swollen current account deficit. Freezing the rate at current levels will actually cause the hryvnia to appreciate in real terms because local inflation is far higher than dollar inflation. The IMF is aware of this policy dilemma, and believes that the NBU's current stabilization measures can only be a short-term remedy to reestablish confidence and prepare the economy, and society as a whole, for what needs to come next: namely more exchange rate flexibility and managed further depreciation. Allowing the hryvnia to depreciate may become very difficult, both politically and psychologically, for Ukraine. End comment.

TAYLOR